IN THE MATTER OF THE APPLICATION REGARDING CONVERSION OF PREMERA BLUE CROSS AND ITS AFFILIATES

Washington State Insurance Commissioner's Docket # G02-45

PRE-FILED DIRECT TESTIMONY OF:

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Senior Vice President and Chief Actuary
Premera Blue Cross

March 31, 2004

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Introduction

Q. Please state your name.

A. Audrey Lynn Halvorson.

Q. Please identify your employer and state your position.

A. I hold the position of Senior Vice President and Chief Actuary with PREMERA Blue Cross.

Summary of Testimony

Q. Please summarize your direct testimony?

A. Premera's premium rates are regulated by the OIC, and they are developed through actuarial principles. Premera does not and cannot vary its premium rates in any geographic area of the state in the individual or small group markets to increase its operating margins relative to the margins in other geographic areas. Premera also has provided rate-related assurances as to small group and individual premium rates which should satisfy the state's consultants concerns about the effect of the conversion on premium rates.

Credentials

Q. Please describe your professional background.

A. I joined Premera Blue Cross in July, 2000 as Vice President of Actuarial Services. I was promoted to my current position in April, 2001. From April, 1984 until joining Premera Blue Cross I was a Health Care Management Consultant with Milliman & Robertson, Incorporated, except for five months in 1990, when I worked at Cologne Life Reinsurance company. Between June, 1982 and April, 1984 I was an Actuarial Student with The Hartford Insurance Group. I am a Member of the American Academy of Actuaries and a Fellow of the Society of Actuaries.

Q. Please describe your past and current job positions and responsibilities.

A. At the Hartford Insurance Group, I had two positions. In the first, I was an actuarial student working in the reporting area. I worked on life insurance reserves. In the second, I worked in a special health rating area, and estimated rate changes for changes in deductibles, coinsurance or out-of-pocket maximums.

I then joined Milliman & Robertson, Inc. in the Hartford, Connecticut, office, and worked on life insurance products, reserving for life insurance companies, and consulting to health insurers. Representative health care consulting engagements included: developing Health Maintenance Organizations premium rates, calculating reserves for disability products, supporting the sale of a block of disability insurance, assisting in the demutualization of a mutual health insurance company, and developing reserves for a Continuing Care Retirement Community.

I spent five months at Cologne Life Reinsurance company as a health actuary, working on Medicare Supplement and Long Term Care reinsurance.

I rejoined Milliman in 1991, in the San Francisco office and became an Associate Member (similar to a junior partner). There I worked on HMO, PPO and traditional projects for clients in the areas of premium rate setting, reserving, and provider reimbursement contracting.

I moved to Seattle with Milliman in 1994 and became a Principal (full partner) in 1999. While with Milliman in Seattle representative projects included: premium rate setting, determination of estimated costs of care pathways for new surgical instruments, capitation rate development for risk taking provider groups, and development of integrated delivery system reimbursement/risk sharing strategies. I was also involved in

developing a risk based capital leasing process with reinsurers. Clients included Blues plans, HMOs, provider owned HMOs, integrated delivery systems, capitated provider groups, and a surgical instrument manufacturer.

At Premera, I am responsible for 3 actuarial units: Corporate Actuarial, MBS Actuarial, and R&D Actuarial. I am also responsible for the Financial Planning and Analysis Department, and Business Information Services unit. My responsibilities at Premera include: the development of premium rates and reserves, research on new risks, development of budgets and financial projections, overseeing the extraction and analysis of corporate data, business development of the enterprise data warehouse, and development of employer group standard reports. I am also involved in contracting with various vendors for services, such as our Pharmacy Benefits Manager and our Disease Management vendors.

Q. Please describe any actuarial committees you have been a member of during your career.

A. I was a member of the American Academy of Actuaries committee that developed the Actuarial Standard of Practice for Continuing Care Retirement Communities. I am also a member of the American Academy of Actuaries committee called the Health Liquidity Work Group that is working on designing liquidity standards for the NAIC. I was also a member of the Society of Actuaries Futurism Section Council.

Q. Please describe any publications you have authored.

A. While at Milliman, I authored two research reports. The first is titled, "Risk Based Capital Requirements for Managed Care Organizations" and the other, "Acuity-Severity Adjusted Inpatient Hospital Reimbursement Arrangement." Also while at Milliman, I authored a chapter of a book entitled, "Thriving in Capitation". The chapter was titled,

"Global and Professional Services Capitation." While at Premera, I authored the chapter titled "Prescription Drug Benefits" of the book, "Group Insurance."

Q. Please describe your educational background.

A. I received a Bachelor of Business Administration, Actuarial Science from the University of Wisconsin. I have completed the actuarial exams administered by the Society of Actuaries and been awarded the status of Fellow of the Society of Actuaries.

Regulation of Rates in Washington

Q. Please describe how Premera's health care coverage rates are regulated in Washington.

A. Premera's insured health care coverage rates are regulated by the Washington Office of the Insurance Commissioner (OIC). Carriers must file rates, other than rates for negotiated group contracts, with the OIC prior to use in the state. Rates for negotiated group contracts must be filed within 30 working days after the date the contract negotiations are complete or the date renewal premiums are implemented, whichever is earlier.

The Rates and Forms Division of the OIC reviews rate filings under Title 48 of the Revised Code of Washington and Title 284 of the Washington Administrative Code.

My understanding is that filed rates for Premera's individual, small group and large group contracts may be disapproved by the OIC if they violate the law. Chapters 48.43 and 48.44 of the Revised Code of Washington and chapters 284-43 and 284-44 of the Washington Administrative Code contain the main applicable provisions of law.

The individual and small group markets are commonly referred to as the "regulated markets". The OIC's review of individual and small group contract rate filings is usually conducted by an actuary working within the Rates and Forms Division.

Such review often includes communication with Premera to clarify questions or concerns about the filing. I am not aware of the OIC failing to review any Premera individual or small group rate filing.

Q. How are premium rates determined, generally?

A. Premium rates, in general, are determined by projecting the expected health care costs of a given population to the time period the insurance is to cover and adding a retention load for administrative expenses and contingency and risk. These rates are called the base rates. Adjustment factors are then applied to the base rate to reflect particular benefit plans purchased by groups or individuals, age and family composition of the purchaser, network chosen, geographic region the purchaser resides in, and coverage time period (effective period). This effective period is typically 12 months long.

Small Group Contract Rating

Q. How are small group contract rates determined?

A. Premium rates for small group contracts are based on a community rate. When determining the rate for an employer, the community rate may be adjusted only for plan design, geographic area, family size, age, and the use of wellness activities. The resulting rate is termed the "adjusted community rate".

Identical groups within a geographic area must receive rates that differ only by amounts attributable to plan design and differences in wellness activities. Therefore, identical groups within a geographic area purchasing the same benefit plan are charged identical rates.

The community rate is based on the expected cost of covering all small groups purchasing coverage from Premera statewide. The expected costs include the costs of

medical claims, administrative expenses, commissions, premium tax and high risk pool assessments. A provision for contribution to surplus (contingency and risk) is added and a credit for interest on incurred but not reported claims is subtracted to determine the total revenue requirement for the rating period.

Medical claims experience makes up the vast majority of the cost. When calculating the community rate, the medical experience of all small groups purchasing coverage from Premera must be pooled.

Premera's geographic area adjustments to the community rate are based on expected differences in unit costs for hospital and professional services within a defined area, efficiencies of the various networks by area, and then adjusted for the pattern of where policyholders living within the area are expected to receive care. The geographic area adjustments are based on the expected costs for members in that particular area, not on the expected payments to the providers in that particular area. This is due to the fact that our provider networks are statewide, and members are allowed to use any provider in the networks chosen across the state, rather than being limited to the providers in the area where the members live or where their employer is located.

Family size adjustments to the community rate are based on the composition of a family unit. Premera uses both "6-tier" and "4-tier" family composition rating factors. In a "6-tier" system family rates are calculated based on the composition of the family as follows: (i) employee only, (ii) employee and spouse, (iii) employee, spouse and one child, (iv) employee, spouse and more than one child, (v) employee and one child, and (vi) employee and more than one child. In a "4-tier" system family rates are calculated based on the composition of the family as follows: (i) employee only, (ii) employee and

spouse, (iii) employee, spouse and one or more children, (iv) employee plus one or more children.

Adjustments to the community rate for age must be based on age brackets of no less than five year increments, which begin with age twenty and end with age sixty-five. Employees under the age of twenty are treated as if twenty. Rates for any age group may not be more than 375% of the lowest rate for all age groups.

Benefit relativity factors are based on the expected cost differential between benefit plans, and are statewide factors. The benefit relativity factors are developed using Milliman's health cost guidelines in combination with internal aggregate experience. We use the same benefit relativity factors in each geographic area, as we do not believe the relative cost differential by benefit plan is expected to be different by geographic area.

Q. What regulatory requirements are applicable to small group rates?

A. Small group rates are subject to requirements related to the filing process, method of development and amount. They must (i) be filed with the OIC before they are used, (ii) be based on the adjusted community rate and (iii) not be unreasonable in relation to the amount charged. The commissioner may disapprove rates not meeting these criteria.

Individual Contract Rating

Q. How are individual contract rates determined?

A. Similar to rates for small group, premium rates for individual contracts are based on a community rate. There are, however, some differences in requirements for individual contracts as compared to small group.

Q. Compare the development of individual and small contract rates.

A. For both the individual and small group contract rates, the community rate may be adjusted only for plan design, geographic area, family size, age, and the use of wellness

activities. In addition to these factors, when determining the rate for an individual, the community rate may be adjusted for tenure discounts.

The individual community rate is based on the expected cost of covering all individuals purchasing coverage from an insurer. Again, medical claims experience makes up the vast majority of the cost. When calculating the community rate, the medical experience of all individuals purchasing coverage from an insurer must be pooled.

The adjustments for age and family composition are developed similarly for both the individual and small group contracts.

Premera does not use geographic area factors for our individual products. PwC and Dr. Leffler speculate on why Premera does not use such geographic factors. The answer to this is simple; the systems on which we currently administer our individual business are not capable of doing so.

Q. What regulatory standards are applicable to individual contract rates?

A. Just like small group rates, individual contract rates are subject to requirements related to the filing process, method of development and amount. They must (i) be filed with the OIC before they are used, (ii) be based on the adjusted community rate and (iii) be reasonably expected to result in a loss ratio that meets or exceeds the loss ratio standard set by the legislature of 74%, less applicable premium taxes. The commissioner may disapprove rates not meeting these criteria.

PricewaterhouseCoopers Report

Q. Are you familiar with the report entitled "Economic Impact Analysis of the Proposed Conversion of Premera Blue Cross for the State of Washington" dated October 27, 2003 and supplemented on February 27, 2004, prepared by PricewaterhouseCoopers (PwC Economic Impact Report)?

A. Yes, I have read the initial report and the supplement.

Q. Do you have any comment regarding the PwC Economic Impact Report related to Premera's prospective premium rates?

A. The PwC Economic Impact Report reaches certain conclusions about the effect of having shareholders on Premera's post-conversion premium rates. PwC's conclusions are based on certain assumptions about Premera's future operating margin targets. I believe PwC's conclusions are in error because it made errors in its assumptions.

The conclusions are based on the erroneous assumption that Premera's operating margin targets are other than those found in the Form A Statement financial projections and the supporting materials to those projections provided to the state's consultants. As stated in Mr. Marquardt's testimony in this case, Premera's projection model on file with the OIC contains Premera's future operating margin expectations. Those expected operating margins assume that Premera has limited ability to increase premiums over health care cost trends due to market competition (except where health care cost experience has been worse than expected). Premera's projected financial results, therefore, are generally based on premium rates which change at the same rate as health care costs. That is, projected premiums increase at the same rate as expected trend. The percentage of claims expense to revenue thereby remains largely the same over the period of the projections.

PwC used expected margins in its report which are different than those in Premera's Form A Statement financial projections. The PwC report ignores the operating

margin goals found in the Form A Statement which were reviewed and approved by Premera's Board. PwC substituted higher operating margin goals and then concludes that Premera will need to either attain greater savings in health care costs or administrative expense or to increase premiums to achieve the operating margins which PwC itself assigns. It then concludes that post-conversion premium rates will increase in eastern Washington in certain lines of business to meet those higher margins. I don't agree with that conclusion because PwC ignored the operating margins we used in our projections and unilaterally assigned different operating margin assumptions.

Q. Is there another reason you disagree with their conclusion about premium rates in eastern Washington?

A. The report declares that Premera may be able to increase operating margins in eastern Washington in the individual and small group lines of business. PwC also presented an economic model to quantify the potential impact on premiums if Premera had the ability and desire to increase operating margins in those areas in those lines of business.

The report does not explain how Premera could increase margins in eastern Washington in relation to margins in other parts of the state. It simply assumes this without assessing how existing regulations affect setting of premium rates. I do not believe that current community rating requirements under Washington law provides the ability to affect eastern Washington individual and small group rates the way PwC suggests.

Q. Has Premera addressed PwC's concerns related to prospective rate increases?

A. Yes. The PwC Economic Impact report suggests that Premera's current rating practice in the regulated individual and small group markets do not, and would not, if

applied consistent with current practices, lead to percentage increases in premium rates in eastern Washington in excess of those in western Washington. The PwC report expresses concern, however, that New Premera Blue Cross Corp. might change certain practices, and thereby increase premium rates in excess of heath care cost in its regulated individual and small group lines of business in certain counties in the eastern portion of the state of Washington in order to increase margins to meet investor expectations.

Subsequent to the issuance of the PwC Economic Impact Report, Premera, PwC and the OIC Review Staff engaged in discussions regarding concerns expressed by PwC in relation to the economic impact of the proposed reorganization. To address the concerns expressed in the PwC Economic Impact Report regarding the impact of the reorganization on regulated individual and small group premium rates, Premera filed certain assurances in its February 5, 2004 amendment of the Form A. Those assurances include continuing Premera's current practices of (i) utilizing statewide benefit relativity factors, (ii) using statewide broker commissions, and (iii) having no differentiating between eastern and western Washington in its management and sales incentives plans for the individual and small group lines of business, respectively. Such assurances should eliminate the concerns raised by PwC about increased premium rates in excess of heath care cost trends in Premera's regulated individual and small group lines of business in the eastern portion of the state of Washington during the term of the assurances. In any case, whether during or after the term of the assurances, I do not agree with PwC that Premera could increase margins for targeted portions of the state for the reasons given in my response to the prior question.

Q. Have you read Dr. Leffler's report entitled "Antitrust Review By The Office Of Insurance Commissioner" filed in this matter?

A. Yes, I have read that report.

Q. Dr. Leffler states that the geographic area factors by network reflect the provider reimbursement level differences by area. Do you agree with this comment?

A. No, I do not. The network/geographic factors reflect the estimated relative cost of care that is expected to be provided to members who live in each of the areas, not just the differences in provider reimbursement levels. As stated previously, Premera's geographic area factors are based on expected differences in unit costs for hospital and professional services within a defined area, efficiencies of the various networks by area, and then adjusted for the pattern of where policyholders living within the area are expected to receive care. Therefore, the differences in provider reimbursement levels by area are only one of the three factors used to develop the geographic factors.

Q. Did you read the Milliman report on Comparative Premium Rate Analysis?

A. Yes, I did.

Q. Do you generally agree with the conclusions in the report?

A. I do generally agree with the conclusions in the report.

Q. Did you read the NovaRest report on Risk Based Capital?

A. Yes, I did.

Q. Do you generally agree with the conclusions in the report?

A. Yes, I do generally agree with the conclusions in the report.

Q. Does this conclude your testimony?

A. Yes, it does.

VERIFICATION

I, AUDREY L. HALVORSON, declare under penalty of perjury of the laws of the State of Washington that the foregoing answers are true and correct.

Dated this ____ day of March, 2004, at Mountlake Terrace, Washington.

/s/
AUDREY L. HALVORSON